

DEPARTMENT OF STATE REVENUE

**LETTER OF FINDINGS NUMBER 94-0683 ITC
Adjusted Gross Income Tax
For Calendar Years 1987 Through And Including 1990**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax - Add Back of Taxes

Authority: IC 6-3-1-3.5(b); 45 IAC 3.1-1-8; IRC Section 61; IRC Section 62; *Trinova Corporation v. Michigan Department of Treasury*, 498 U.S. 358 (1991); *Dayton Hudson Corp.*, Cal St. Bd. of Equal., Feb. 4, 1994 (94-SBE-003); *Miles v. Department of Treasury*, 209 Ind. 172 (1935);

The taxpayer protested the Department's failure to eliminate taxes added back to federal taxable income by the taxpayer in the preparation of the Indiana return.

II. Adjusted Gross Income Tax - Foreign Source Dividend Deduction

Authority: 45 IAC 3.1-1-56; IRC Sections 861, 862, and 863

The taxpayer protested the reduction of the modifications for foreign source dividends and foreign gross-up by related expenses as reflected on the federal form 1118.

III. Adjusted Gross Income Tax - Business/Non-business Income and Expenses

Authority: 45 IAC 3.1-1-60

The taxpayer protested the characterization of dividends received from companies owned equal to or less than fifty percent (50%) as business income.

IV. Adjusted Gross Income Tax - Expenses Related to Non-business Foreign Interest Income

Authority: 45 IAC 3.1-1-56; IRC Sections 861, 862, and 863

The taxpayer protested the use of total foreign source expenses to apportion expenses to non-business foreign interest income.

V. Tax Administration - Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-1 & 2

The taxpayer protested the imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

The taxpayer was incorporated on June 11, 1947, under the laws of the State of Delaware. The taxpayer is vertically integrated. The taxpayer produces a wide variety of products. The taxpayer is an international conglomerate. Additional facts will be introduced as necessary.

DISCUSSION

I. Adjusted Gross Income Tax - Add Back of Taxes

The taxpayer protested the Department's failure to eliminate taxes added back to federal taxable income by the taxpayer in preparing its returns. The taxpayer added back "franchise taxes" and Michigan Single Business Tax (MSBT) on the original Indiana corporate income tax returns. The taxpayer alleged that the department did not reverse these calculations when the taxpayer was audited.

The term adjusted gross income for corporations is defined under IC 6-3-1-3.5(b) which provides, the following:

In the case of corporations, the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follow:

...

(3) Add an amount equal to any deduction or deductions allowed or allowable pursuant to Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States or for taxes on property levied by any subdivision of any state of the United States. (Emphasis added).

The taxpayer protested the add back of MSBT, as a tax which is not sufficiently based on or measured by income to be added back. The taxpayer argues that MSBT is a value-added tax rather than a "net income" tax, and cites *Trinova Corporation v. Michigan Department of Treasury*, 498 U.S. 358 (1991) and *Dayton Hudson Corp.*, Cal. St. Bd. of Equal, Feb 4, 1994 (94-SBE-003).

The Department agrees that the MSBT is not a tax on net income. The code does not require the add back of only net income taxes, but requires the add back of taxes based on or measured by income, a broader category than that argued. MSBT uses federal taxable income as a starting point and then makes several adjustments to arrive at what is essentially a gross income figure. An analogy can be drawn between MSBT and the Indiana gross income tax, the latter of which must be added back in computing Indiana adjusted gross income for corporations, which pay gross income tax. See 45 IAC 3.1-1-8 and *Miles v. Department of Treasury*, 209 Ind. 172 (1935). While these two taxes are computed differently, they are similar in that both include more than just a net income tax component. The Department is of the opinion that the MSBT is sufficiently based on or measured by income, (as is the Indiana gross income tax) to be required to be added back to federal taxable income for adjusted gross income computations.

The taxpayer also protests the add back of "franchise taxes". The code does not require the add back of only net income taxes, but requires the add back of taxes based on or measured by income, a broader category than that argued. If the taxpayer is subject to a franchise tax measured by net income, the "franchise tax" would be added back. The taxpayer did not designate the state franchise taxes that were being protested. The taxpayer

did not meet its burden of proof.

FINDINGS

The taxpayer's protest is denied.

II. Adjusted Gross Income Tax - Foreign Source Dividend Deduction

The taxpayer protested the reduction of the subtraction modifications for foreign source dividends and foreign gross-up by related expenses as reflected on the Federal Form 1118.

The Department used Federal Form 1118 to determine the amount of non-business expenses. For federal income tax purposes, Federal Form 1118 is used to determine the available amount of foreign tax credit. From Federal Form 1118, the auditor determined the ratio of non-business dividend income to total foreign income. Internal Revenue Code Section 862(b) and Federal Form 1118 requires the taxpayer to allocate to sources of gross income from within and without the United States the ratable part of any expenses, losses, or deductions which cannot be definitely allocated to a class of gross income.

Administrative Rule 45 IAC 3.1-1-56 provides that "[w]hen the taxpayer has deductions [expenses] applicable to both business and non-business income, such deductions [expenses] must be prorated to determine what part is subject to allocation." Neither the Indiana Code nor the Administrative Rules provide a method for determining the amount of expenses associated with non-business income. The provisions for the foreign tax credit on Federal Form 1118 are allocated at IRC ' 861. Internal Revenue Code ' 863(a) provides the following:

Items of gross income, expenses, losses, and deductions, other than those specified in sections 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the taxable income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some items or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

Internal Revenue Code Section 863 and the Regulations provide the means for allocating items of gross income expenses, losses, and deductions to sources within and without the United States. Here the department is attempting to allocate various expenses and deductions associated with the foreign dividend income to its source. Neither the Indiana Code nor the Administrative Rules provide a method for determining the amount of expenses associated with non-business income. Other states use purely arbitrary percentages to determine the amount of expenses associated with non-business income. Therefore, until a satisfactory alternative method is found, the Internal Revenue Code and Administrative Rules shall be used to determine the amount of expenses that are related to the dividend gross-up.

FINDINGS

The taxpayer's protest is denied.

III. Adjusted Gross Income Tax - Business/Non-business Income and Expenses

The taxpayer protested the characterization of dividends received from companies owned equal to or less than fifty percent (50%) as business income. The taxpayer contends that all dividends that it receives from companies in which its ownership is less than or equal to fifty percent (50%) qualify as non-business dividends under 45 IAC 3.1-1-60 and should be deducted from income to be apportioned to Indiana. 45 IAC 3.1-1-60 provides in pertinent part:

Dividends are non-business income if the stock with respect to which the dividends are received did not arise out of or was not acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is not related to or incidental to such trade or business operation.

The taxpayer stated that there is no unitary relationship between the taxpayer and any of the companies where the ownership is in the twenty percent (20%) to fifty percent (50%) range. Where the ownership is less than twenty percent (20%), the taxpayer argues that the securities are clearly part of a portfolio of stock held for investment purposes.

In determining whether income is business or non-business, the Department does not consider the percentage of ownership. The Department looks to whether the income is acquired in the regular course of the taxpayer's trade or business operations. In this case the taxpayer is a vertically integrated manufacturer. The taxpayer produces a wide variety of products. The auditor did exclude two corporations in this audit consistent with the findings of the first hearing.

FINDINGS

The taxpayer's protest is denied.

IV. Adjusted Gross Income Tax - Expenses Related to Non-business Foreign Interest Income

The taxpayer protested the Department's use of total foreign source expenses (per Federal Form 1118) to apportion expenses to non-business foreign interest income. The taxpayer contended that Indiana's administrative rules do not require non-business income to be reduced by related expenses. The taxpayer argued that the expenses related to non-business foreign interest income calculated in the audit are excessive. The taxpayer states that Federal Form 1118 includes many types of expenses that do not have a relationship to interest income. In the alternative, the taxpayer suggested that expenses related to non-business foreign interest income be recalculated based on the percentage of foreign non-business interest income to total foreign income multiplied by foreign interest expenses.

The Department in Issue II of this Letter of Findings has made a determination on the use of Federal Form 1118 in calculation the amount of related expenses.

FINDINGS

The taxpayer's protest is denied.

V. Tax Administration - Penalty

The taxpayer protests the Department's imposition of the ten percent (10%) penalty assessment. Indiana Code

section 6-8.1-10-2.1 requires a ten percent (10%) penalty to be imposed if the tax deficiency is due to the negligence of the taxpayer. Department regulation 45 IAC 15-11-2 provides guidance in determining if the taxpayer was negligent in nature.

Departmental regulation 45 IAC 15-11-1(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is also to be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.

Subsection (d) of IC 6-8.1-10-2.1 allows the penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Departmental regulation 45 IAC 15-11-28 requires that in order to establish reasonable cause, the taxpayer must show that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty."

The taxpayer has not met the burden of proof.

FINDINGS

The taxpayer's protest is denied. The taxpayer did meet the burden of proof.